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SUBJECT: Carabobo Bid Round Update & Venezuela's New Petroleum
Strategy

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CLASSIFIED BY: Darnall Steuart, Economic Counselor, DOS, Econ;
REASON: 1.4(B), (D)

¶1. (C) SUMMARY: The final terms and conditions for the Carabobo extra heavy oil bid round were issued at the end of November. While they do not contain all of the changes hoped for by potential bidders, there were enough alterations to make it possible that international oil companies may submit bids before the end of January 2010. This bid round underlines the extent to which Venezuela has changed its strategic plan for the development of its oil resources, putting an emphasis on the development of the Orinoco heavy oil belt and on new joint ventures with international and national oil companies. While the plans are aggressive and may or may not meet with success, the shift away from developing its resources on its own and once again towards greater reliance on external partners is significant. END SUMMARY.

Carabobo Update

¶2. (C) The Ministry of Energy and Petroleum (MENPET) released the final terms and conditions (T&C) for the Carabobo bid round on November 30, 2009. First launched in October 2008, the process to bid out the Carabobo blocks in Venezuela's Orinoco extra heavy oil belt (the Faja) continues to move along, with bids now due at the end of January. MENPET expects to announce winners in March. A well placed industry insider was given access to the 300 page confidential terms and conditions document and provided a brief analysis of the major points. Most importantly, he believed the latest T&C showed marked improvements that investors will find increase their ability to submit bids.

* The Carabobo T&C provide for a reduction in the extraction tax and royalty (to 20%) if the project does not achieve a pre-determined target return on investment.

* The document includes a reference to the Special Advantage

Tax (or Shadow Tax) which confirms that the tax shall be reduced so as not to cancel out any reduction in royalty and extraction tax. [NOTE: The "shadow tax" guarantees to the state a minimum of 50 per cent of all petroleum rent through royalty and taxes and was introduced into the mixed company contracts in 2007. END NOTE]

* The T&C do not include a target internal rate of return (IRR), but our sources believes MENPET is using an IRR of 10% for its internal calculations.

* The final T&C also restructured the bonus to be offered by the winning bidders, stating that the minimum $1 billion bonus (or $500 million bonus depending on which project bid on) will be paid in six installments.

¶3. (C) Our source described several challenges that remain in the private sector's decision-making process, most of which relate to the experiences of the last couple of years of those companies that have worked with PDVSA as minority partners in either the joint venture (the former Strategic Associations) or mixed company frameworks (the former Operating Service Agreements). The T&C expressly forbid the conditioning of bids (one strategy discussed

by the oil companies to account for many of the gray areas that remain in the T&C). For some companies, PDVSA has yet to pay dividends for 2008 mixed company operations. The international companies also see the dire operational state of the country's heavy crude upgraders (which some of them built) that were nationalized in mid-2007. With three of the four upgraders currently shut down, and too many safety and maintenance problems to mention, the prospect that PDVSA would operate a greenfield project in the same manner it is operating the four current upgraders is a clear deterrent. Bidders that currently operate in mixed companies note that their presence has, at times, been barely tolerated by PDVSA, whose unilateral application of conditions not considered in the original mixed company agreements has created increased risk and prolonged negotiations on any new projects. Finally, there is President Chavez, whose stated intention to transform Venezuela into a socialist country has raised questions about whether the Venezuelan state will ultimately abide by any agreement it signs.

¶4. (SBU) Concurrent with the Carabobo bid round, the GBRV is also pressing forward to award blocks in the Junin region of the Faja. Through a non-competitive process it is negotiating bilateral agreements with China, Russia, and Vietnam, and with France's Total and Spain's Repsol, amongst others. In late December, PDVSA announced an exploration and certification agreement with China's CNPC for the Faja's Boyaca 3 block. With few exceptions, PDVSA is focused on generating new production from the Faja and not from other existing fields.

Venezuela's heavy oil strategy

¶5. (SBU) These developments in the Faja underline Venezuela's intent to pin its oil production future largely on the development of its extra heavy crude resources. The World Heavy Oil Congress (November 3-5) provided Minister of Energy and Petroleum Rafael Ramirez with a platform from which to share the GBRV's updated vision of project development in the Orinoco heavy oil belt. Ramirez also revealed that PDVSA's new business plan for 2010-2021 contemplates increasing crude oil production by 3.653 million barrels per day (MBD). Assuming PDVSA's success, production could grow from PDVSA's current stated production level of 3.209 MBD in 2010 to 6.862 MBD in 2021. [NOTE: International secondary sources peg Venezuelan production at 2.3 MBD. END NOTE.] PDVSA's 2005-2010 "Siembra Petrolera" (Sowing Petroleum) plan envisioned

the majority of new production to come from PDVSA-only activity in traditional fields, but the new plan appears to rely on private sector participation to increment production through the joint venture model. It forecasts that new Faja projects will contribute 2.791 MBD to the goal, or 76% of new production.

¶6. (SBU) In terms of investment, the 2010-2021 plan details the highest levels of investment ever seen in the Venezuelan oil sector. According to Ramirez, from 2005 to 2009 PDVSA invested $51.3 billion. Total planned investment for the 2010-2015 period is $224.4 billion, almost half of which will be divided equally between natural gas and extra heavy oil development. Average capital expenditures under this plan appear to reach $45 billion annually. [NOTE: Venezuela's 2009 export revenue from petroleum sales is projected at $57 billion. END NOTE]

¶7. (SBU) According to MENPET, Faja production is expected to grow

by 3.6 MBD by 2021; 2.8 MBD of that from greenfield developments (1.2 MBD from Carabobo and 1.6 MBD from Junin). PDVSA expects this development to cost $118.6 billion. Additionally, Ramirez presented six new upgraders for extra heavy crude to be developed before 2020 and two new refineries (a 400,000 b/d refinery in Cabruta to be built in two phases and a 300,000 b/d refinery to be constructed in the Jose condominium targeted to begin operations in 2019). Ramirez mentioned that Faja development will include the drilling of 10,570 wells, the construction of 2,002 km of oil pipelines, storage infrastructure (28 tanks of 750,000 BBL and 5 tanks of 500,000 BBL), a liquids terminal in Araya and a solids terminal in Punta Cuchillo (located near Ciudad Guayana). All of this is in addition to already announced plans for the construction of two LNG trains and several petrochemical plants.

¶8. (C) While PDVSA's plans are grand, it is worthwhile to note that the four original "Strategic Association" projects to process Venezuela's extra heavy crude were under development for approximately eight years. The development of these projects was handled by some of the largest and most experienced international oil and engineering companies. No one expects PDVSA-managed projects in the Faja to be able to match or exceed the record of the international companies, especially as these will be greenfield projects dependent on the GBRV to deliver infrastructure such as workers homes, roads, electrical supplies, water and sewage, etc. However, President Chavez has stated that he expects the first cold crude production to be realized from Carabobo by 2011, even though first production from the more advanced Junin project with the Russian consortium is not expected prior to 2016.

¶9. (C) Comment: The GBRV's strategy shift might be an admission that it has made little progress in identifying new production opportunities and has been unable to develop reserves under its own efforts due to PDVSA's inability to execute new production projects on its own, financial and/or human resource restrictions, or a strategic reorientation of efforts towards heavy crude. PDVSA needs foreign investment and expertise to develop the Faja, but raised the ante on foreign partners by ruling out conditional bids in Carabobo, making it more difficult for them to make a case for billions of dollars of new investment here (including financing PDVSA's share, with little to no operational role in the mixed companies, limited access to international arbitration, and no real control over governability of the mixed companies). Questions abound about how the country will provide sufficient human resources, sufficient natural gas for required secondary recovery, sufficient diluents, sufficient capital, sufficient governability, sufficient contract sanctity, etc. for so many projects at once. That said, international oil company sources acknowledge that there is zero below ground risk in considering the Faja projects, only

above ground, political risk. Given the GBRV's reoriented strategy that relies heavily on joint ventures in the Faja, qualified investors will likely submit bids, assuming that PDVSA will have to mend its ways and work integrally and intelligently in order to get any new extra heavy crude projects built. END COMMENT.
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